MONETARY POLICY REPORT

September 2017

Central Bank of Paraguay

Executive Summary*

Since the last IPoM, the dynamism of the global economy continues to improve, boosted by the favorable performance of the main advanced economies as well as the emerging ones. In the United States and the Eurozone, activity and labor market indicators continued to consolidate. Likewise, in China, the economic results stood above the forecasts, which has led to an upward correction in growth forecasts. In the region, both Brazil and Argentina continue to show signs of improvement, although a certain degree of uncertainty persists as regards the consolidation of this economic recovery.

World growth
Annual change, percent

	June 2017		September 2017	
	2017	2018	2017	2018
World	3.4	3.5	3.4	3.5
United States	2.2	2.3	2.2	2.3
Eurozone	1.9	1.7	2.1 ▲	1.8 ▲
China	6.6	6.3	6.7 ▲	6.4 ▲
Brazil	0.5	2.1	0.7 ▲	2.4 ▲
Argentina	2.8	3	2.8	3.1 ▲
Trading partners	1.9	2.4	2.1 ▲	2.5 ▲
Trading partners - Mercosur	1.1	2.3	1.3 ▲	2.5 ▲

Source: Bloomberg

In the United States, economic activity showed a greater dynamism in recent months, compared to the modest growth observed in the first quarter 2017. With respect to this, the expansion of the Gross Domestic Product (GDP) in the second quarter was boosted by an acceleration of personal consumption expenditures and the upturn of both private investment and federal government spending. On the other hand, leading activity indicators show signs of similar behavior in the third quarter of the year. As regards monetary policy, the Federal Reserve kept the interest rate of Federal Funds unchanged since June meeting. However, the market foresees a new adjustment towards the end of the year, taking into account the greater probability of a rate hike in the recent period. Likewise, the Fed has made the decision to initiate the reduction of its balance sheet within the next months.

In the Eurozone, economic activity and manufacturing sector indicators continued to evolve favorably. In the second quarter, the GDP grew at a higher annual rate than that registered in the previous quarter, while the PMI continued to increase within the expansion zone. Similarly, the labor market continued to strengthen, reflected in the unemployment rate in August (9.1%) which is the lowest since February 2009. As regards monetary policy, the European Central Bank (ECB) maintained the reference interest rates unchanged and continued with the purchase of assets, in an amount similar to that indicated in the previous Report.

In China, the economic activity indicators in the second quarter expanded above the expected levels. This growth was driven by increases in manufacturing output, exports, and investment in fixed assets. However, leading indicators show signs of a deceleration in the third quarter, explained

* The Spanish version prevails.

Gross Domestic Product by sectors
Annual change, percent

	2016	2017(f)	2017(c)
Primary Sector	2.9	4.5	1.1
Agriculture	2.5	5.3	1.0
Livestock	3.7	1.5	0.1
Others	5.8	4.9	0.0
Secondary Sector	10.4	2.0	0.5
Manufacturing	5.4	9.4	1.0
Construction	18.6	5.0	0.2
Binationals (Electricity & water)	12.6	-6.0	-0.7
Tertiary Sector	1.4	5.3	2.2
Public Administration	-2.8	1.7	0.1
Trade	2.9	7.8	1.1
Communications	-2.7	1.9	0.1
Other Services	3.3	5.7	0.9
Taxes	0.9	5.0	0.3
GDP at market prices	4.0	4.2	4.2
GDP w/o agriculture and binationals	3.2	5.6	

Source: Central Bank of Paraguay
(f): Forecast
(c): Contribution to the GDP growth

to some extent by the government's policy which seeks to contain the exposure to financial risks through a tightening of credit conditions.

In the region, the Brazilian economy registered a moderate expansion of the GDP in the second quarter, after experiencing twelve consecutive quarters of negative results. This behavior is due mainly to the positive contributions of farming and livestock activities on the supply side, and the increase of exports and private consumption on the demand side. Furthermore, the leading indicators in the third quarter continued to evolve favorably, giving clearer signs of the recovery of economic activity. Nevertheless, political uncertainty remains as a risk factor that could affect the better performance observed in the last few months. Regarding monetary policy, inflation remained to decline, giving space to the Central Bank of Brazil's Monetary Policy Committee (Copom) to continue with its reduction of the Selic rate.

In Argentina, the GDP expanded for the second consecutive quarter, exhibiting a growth rate much higher than that registered in the previous quarter. In addition, during the third quarter the short-term economic activity indicators continued to show signs of recovery. Regarding prices, annual inflation, which had showed a downward trajectory, increased in August. However, it is expected that this increase will be transitory and gradual reduction of inflation will continue.

At the local level, economic activity registered less expansion in second quarter of 2017, due largely to adverse weather conditions that specially affected the construction and livestock sectors. In this period, the GDP registered a growth rate of 0.9% y-o-y, explained mainly by the expansion of the services, manufacturing, and agriculture, sectors from the supply side. On the expenditure side, growth was chiefly explained by domestic demand (private consumption and investment), given the fall of net exports (greater expansion of imports than exports). With respect to leading indicators, it is expected that economic activity would register a more favorable performance in the third quarter, and that domestic demand will continue with the dynamism that has been shown during the year.

In relation to prices, total inflation averaged a rate of 4.1% in the third quarter, higher than the rate observed in the previous period (3.3%). This result is explained by the increase in the prices of a few products of the Consumer Price Index's basket, particularly the volatile items that formerly had shown negative annual rates. In the third quarter, the annual average rates of underlying inflation (4.1%), underlying X1 (4.7%), and core inflation (3.1%) were lower than those registered in second quarter 2017 (4.7%, 5.5%, and 3.3%, respectively). In part, lower rates were due to the smaller annual variation in the prices of meat, dairy products and sugar, which had previously explained the upward trajectory of some of these inflation trend measures.

At monetary policy meetings, the Open Market Operations Committee (CEOMA) highlighted that the favorable evolution of the main advanced economies continues to be observed. Meanwhile, in the region, the Brazilian economy had shown a certain improvement at the margin, even though a high degree of uncertainty still persisted as regards the strength of its recovery. Regarding the domestic scenario, the economic activity presented a moderation of its expansion pace in the second quarter, explained largely by specific factors, especially those associated with weather conditions. Nevertheless, new data verified in June showed a deceleration that comprises more sectors. At the same time, a downward trajectory of different measures of underlying inflation were observed, and expectations remained anchored to the inflation target. Given this scenario, the CEOMA considered it timely to adopt a more expansive monetary policy stance in August, reducing the monetary policy reference rate by 25 basis points to 5.25% annually. At its following meeting, the Committee deemed that no further adjustment of the reference rate was warranted.

In the baseline scenario, the growth projection remained at 4.2%, although some sectorial changes were carried out, taking into account the recent evolution of the short-term indicators, as well as the most likely scenario for the rest of the year. On one hand, the growth prospects were revised upward for agriculture, manufacturing, and commerce. On the other hand, growth estimates were revised downward for the expansion of livestock and construction, sectors that were strongly affected by adverse weather conditions during the second quarter. Likewise, growth estimates were adjusted downward for the binationals electric power production. On the expenditure side, the growth rates for private consumption and investment remained similar to the rates cited in the previous report, while net external demand was reviewed downward, basically due to a greater positive adjustment of imports with respect to exports. In general, economic growth in 2017 is mainly explained by commerce, other services, and manufacturing (on the side of supply), and by both consumption and investment (on the side of expenditures).

As concerns total inflation, in the baseline scenario, the projected inflation rate for December 2017 increased to 3.8%, as compared to the 3.5% rate estimated in the June IPoM. This result is due basically to the increase of certain volatile

Economic growth and current account
Annual change, percent

	2015	2016	2017(f)
GDP	3.0	4.0	4.2
Domestic demand	1.7	2.3	5.4
Gross capital formation	1.2	6.4	11.5
Gross fixed capital formation (GFKF)	2.2	7.9	11.5
Total consumption	1.9	1.2	3.6
Private consumption	1.5	1.7	3.9
Public consumption	4.3	-2.8	1.5
Exports of goods and services	-1.3	2.7	5.0
Imports of goods and services	-4.0	-0.7	7.5
Current account (% of GDP)	-1.1	1.5	0.2
GFKF (% of nominal GDP)	16.4	17.7	19.0
GFKF (% of real GDP)	18.7	19.4	20.7

Source: Central Bank of Paraguay

items prices of the consumer basket that were greater than expected for the third quarter. On the other hand, the estimates of underlying inflation for December 2017 were reduced from 3.6% to 3.4%, explained in part by the realization of a lower exchange rate level than the one estimated for the third quarter which in turn, conditions the expected level for the fourth quarter. Another reason of the inflation declining was a lower positive product gap than that previously estimated. Subsequently, according to the scenario foreseen for internal and external macroeconomic variables, inflation will converge gradually to the target in the relevant monetary policy horizon, in this case, the third quarter of 2019.

Inflation projection
Annual change, percent

	2016	2017(f)	2018(f)	2019(f)
Average CPI inflation(*)	3.9	4.2	3.9	
December CPI inflation (**)	3.9	3.8	3.9	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.7	3.5	3.9	
December underlying CPI (**)	3.6	3.4	3.8	
Underlying CPI inflation in around 2 years (***)				4.0

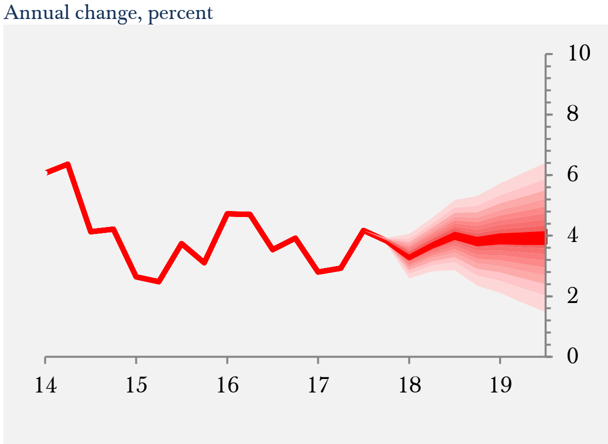
(f) Forecast.
(*) Corresponds to the average of the fourth quarter.
(**) Corresponds the inflation on the end of the period.
(***) Corresponds to the projected inflation for the third quarter of 2019.

With respect to risk scenarios, at the international level, the global economy outlook continues to improve and no significant volatility risks are foreseen in the short-term, even while taking into account the Federal Reserve's plans to continue with the monetary policy normalization process, whether through the increase of interests rate and/or the reduction of its balance sheet. Nevertheless, a more rapid consolidation of the United States' recovery and/or the inflation acceleration (and inflation expectations) might generate greater uncertainty with respect to the adjustment pace of reference interest rates, which could increase the volatility of the financial markets, depreciate currencies, and increase the cost of external funding for emerging economies, including that of Paraguay.

In the Euro zone, both economic activity and the labor market have continued to strengthen. On one hand, the elections in Germany have contributed to moderate the political risks in the zone. However, other risks have arisen, derived mainly from the independence movements in Spain. In addition, uncertainty persists about the Brexit negotiations. An economic weakening of the block might exert an unfavorable bearing on the global growth dynamics and could in turn carry implications for Paraguay's trade partners.

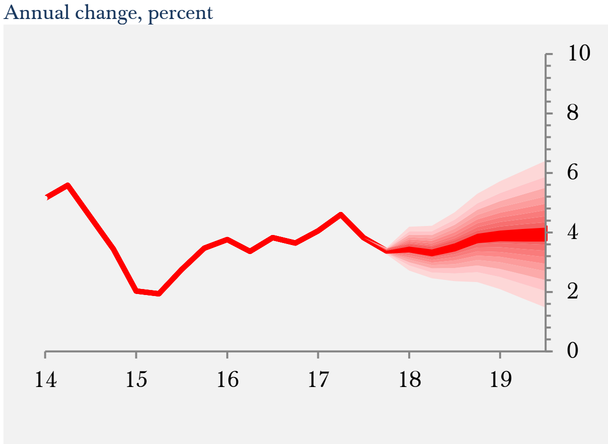
In China, economic growth estimates have been revised upwards, given the positive performance in the last few months. However, a sudden deceleration risk in the medium term would persist if reforms are not adopted regarding the corporate debt recovery policy and the restructuring of the state-owned enterprises. Likewise, another risk factor is the slow process of rebalancing the economy towards consumption and services, which, in a certain measure, could exert an unfavorable effect on the evolution of commodity prices (particularly food items) at the international level.

CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

At the regional level, the Brazilian economy has shown relatively clearer signs of a recovery, although certain uncertainty persists about the concrete realization of some reforms planned by the government. To the extent that this recovery is firmly established, bilateral trade between Paraguay and Brazil could continue to improve, especially trading in the border zones. On the other hand, while Argentina also shows signs of economic activity recovery, inflation remains relatively high and the need for a solid fiscal adjustment persists. To the extent that these high levels of inflation continue and the bilateral nominal exchange rate remains stable, the important flow of commercial operations carried out by Argentinians in cities bordering with Paraguay could continue to be observed in the following months.

In the domestic scenario, the most relevant risk factor is the evolution of the foreign exchange rate. As pointed out previously, the risks appear to be balanced, up until now, although this will depend to a great extent on the United States' new economic data in the upcoming months and the way in which this information is internalized by the financial markets. Even so, in any case, the strengthening of the dollar would be a global phenomenon, affecting not only Paraguay, but also Paraguay's main trade partners. Therefore, the effect upon the real exchange rate might be lower.

Taking into account the alternative scenarios, the CEOMA considers that the balance of risks for inflation is unbiased. Nevertheless, the Committee will continue to be alert to the evolution of the relevant macroeconomic variables for domestic inflation, applying the necessary monetary policy measures that will allow for the convergence of inflation to 4% annually over the relevant projection horizon.